In the Supreme Court of the United States

OCTOBER TERM, 1966

No. 404

FREDERICK J. VILLAFRANCA AND THELMA K. VILLAFRANCA, PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT

MEMORANDUM FOR THE RESPONDENT IN OPPOSITION

This income tax case presents a familiar tax accounting question—whether an accrual basis taxpayer is entitled to deduct a "reserve" for estimated future expenses.

Petitioners are members of an accrual basis partnership which conducts an Arthur Murray School of Dancing in Louisville, Kentucky. Prior to 1956 the partnership reported as gross income only amounts collected with respect to which lessons had already been given. Beginning with 1956 it reported as gross income the total amount received in each year—without regard to whether the lessons had already been

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given. For 1959 (the taxable year here involved) the partnership for the first time claimed a deduction, under the label "Teaching Expense-Reserve," for an estimated amount of future expenses to be incurred in furnishing lessons. (Pet. 20, 21–24.) The Commissioner disallowed this claimed deduction on the ground that the reserve represented estimated expenses "not deductible until paid or incurred" (Pet. 24). The Tax Court, relying chiefly upon this Court's decisions in *Schlude* v. *Commissioner,* 372 U.S. 128, and *American Automobile Assn.* v. *United States,* 367 U.S. 687, sustained the Commissioner's determination (Pet. 24–25). The court of appeals affirmed, holding that those decisions "compel the conclusion which the Tax Court reached" (p. 20).

The decisions of this Court in *Schlude* and *American Automobile Assn.* are dispositive of the instant case, and the decision below is in complete accord with those decisions. Whatever conflict previously existed was resolved by those cases, and there is no occasion for further review by this Court.

1. This case presents basically the same tax accounting question as was decided by this Court in *Schlude* and *American Automobile Assn.* In those cases taxpayers claimed exclusion from gross income (*i.e.,* deferral) of cash received in advance for future services, whereas here petitioners claim a deduction from gross income for estimated future expenses. The Court's rationale in *Schlude* and *American Automobile Assn.* applies with equal force whether the taxpayer seeks to exclude advance receipts from income

or to reduce them by the amount of estimated future expenses.

In *Schlude* the Court refused to permit a dance studio to defer cash received for dance lessons on non-cancelable contracts until the lessons were performed. The Court found such a method of accounting "artificial," since "at the end of each [tax] period, * * * the studio was uncertain whether none, some or all of the remaining lessons would be rendered" (372 U.S. at 135–136). Similarly here, petitioners' method of estimating the future expenses of giving lessons is equally "artificial," since petitioners were, at the end of each tax year, "uncertain whether none, some or all of the remaining lessons would be rendered" and thus whether the estimated expenses would ever be incurred. Indeed, the record shows that a number of students who had paid for lessons under non-cancelable contracts never demanded all of the lessons to which they were entitled (Pet. 22, 26).

This Court recognized that its decision in *American Automobile Assn.* was not limited to deferral of prepaid income, but extended also to the question in this case—the deductibility of estimated future expenses. Immediately after deciding *American Automobile* the Court remanded to the Seventh Circuit for reconsideration a case involving the deductibility of estimated future expenses. *Commissioner* v. *Milwaukee & Suburban Transport Corp.*, 367 U.S. 906. The Seventh Circuit, which had previously allowed a deduction for estimated future expenses (283 F. 2d 279), reversed itself on remand and denied the deduc-

tion (293 F. 2d 628). Even the dissenters in *American Automobile Assn.* recognized that after that decision a taxpayer "will have to include unearned receipts, *without any offsetting deductions for the future cost of earning those receipts*" (367 U.S. at 714, emphasis added).

Moreover, just as the repeal of 1954 Code § 452 (Deferral of "Prepaid Income") demonstrated a Congressional intent to preclude deferral of prepaid income, the contemporaneous repeal of correlative § 462 (Deductibility of "Reserves for Estimated Expenses") demonstrated a Congressional intent to prevent accomplishment of the same net result through the deduction route. See *American Automobile Assn.* v. *United States*, 367 U.S. at 694–697; *Schlude* v. *Commissioner*, 372 U.S. at 134. The front door to reduction of taxable net income having been closed by *American Automobile Assn.* and *Schlude*, petitioners may not reenter by the back door.

2. It is axiomatic that taxable income must be computed on an annual basis, and that a taxpayer may not accelerate the year in which he takes a deduction in an effort to reflect the anticipated long-term economic result of a particular transaction or group of transactions. See *Security Mills Co.* v. *Commissioner*, 321 U.S. 281; *Guaranty Trust Co.* v. *Commissioner*, 303 U.S. 493, 498. An accrual taxpayer may claim a deduction only in the taxable year in which he has paid an expense or his liability to pay it has become fixed. See, *e.g.*, *Security Mills Co.* v. *Commissioner*, *supra*; *Brown* v. *Helvering*, 291 U.S. 193; *Dixie Pine Co.* v. *Commissioner*, 320 U.S. 516; *United States* v. *Ander-*

son, 269 U.S. 422; *Commissioner* v. *Hansen,* 360 U.S. 446.

Petitioners' contention (Pet. 7–10) that the decision below violates the "all events" test for determining the deductibility of an expense under the accrual method of accounting rests upon the erroneous assumption that a contractual obligation *to incur* an expense in a subsequent taxable year is the equivalent of *actually incurring* the expense in the current taxable year. Manifestly, petitioners incurred no fixed liability to their dancing instructors for lessons not yet furnished; such a liability would arise only when the instructors actually gave the lessons. Thus, the "reserve" created by petitioners merely reflected an estimate of future teaching expenses to be incurred, not a fixed liability. This Court has long recognized that "Many reserves set up by prudent business men are not allowable as deductions." *Brown* v. *Helvering, supra,* 291 U.S. at 202.[1]

3. Finally, the deduction for the first time in the partnership's 1959 return of a "reserve" for estimated future teaching expenses constituted a departure from its previous method of accounting (Pet. 20, 23). Yet

[1] See also *Lewyt Corp.* v. *Commissioner,* 349 U.S. 237, 242 (an accrual basis taxpayer may not take "events after the taxable year * * * into account"); *United States* v. *Consolidated Edison Co.,* 366 U.S. 380, 384; *Healy* v. *Commissioner,* 345 U.S. 278, 284–285; *Spencer, White & Prentis* v. *Commissioner,* 144 F. 2d 45 (C.A. 2), certiorari denied, 323 U.S. 780 ("liability for the work done after * * * [the taxable year] had not been incurred for the work had not been performed"); *Streight Radio and Television, Inc.,* v. *Commissioner,* 280 F. 2d 883 (C.A. 7), certiorari denied, 366 U.S. 965.

petitioners neither applied for nor obtained the consent of the Commissioner to such change in accounting method (Pet. 20), as required by the statute (1954 Code, § 446(e)).

The petition for a writ of certiorari should be denied.

Respectfully submitted.

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